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No. 91-1421

In the Supreme Court of the United States

OCTOBER TERM, 1991

UNITED STATES OF AMERICA, PETITIONER

v.

WILLIAM F. HILL AND LOLA E. HILL

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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TABLE OF AUTHORITIES

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1. As we explain in the petition (Pet. 12-14), the decision of the court of appeals threatens to shelter billions of dollars of preference income that Congress intended to tax. Although respondents recognize that the Federal Circuit is a court of national jurisdiction where most (if not all) such claims will be litigated (see Pet. 9, 12-14), respondents assert that there is no need for immediate review because two cases are pending in the Tax Court that now raise the same issue (Br. in Opp. 9).

The cases to which respondents refer were pending in the Tax Court when the decision in the instant case was issued. The taxpayers in those cases chose to amend their claims to seek a recomputation of the minimum tax under the rationale of the surprising *Hill* decision. We would not expect

taxpayers who did *not* have cases already pending in the Tax Court to choose to litigate the issue there, given the now favorable precedent in the Federal Circuit. It will be several years before those Tax Court cases could generate an appellate decision that might conflict with the decision in this case.

In the meantime, as indicated in the petition (Pet. 12), the Internal Revenue Service has received refund claims aggregating more than $400,000,000 in the relatively short time since this case was decided. It is apparent that many more such claims will be filed if the decision is permitted to stand. The decision will thus significantly disrupt and obstruct administrative resolution of large numbers of tax claims involving ultimately billions of dollars of revenues.

It is also unlikely that the taxpayers who are presently in the Tax Court will have incentive to pursue their claims further should they lose in that court. Even if a decision unfavorable to the taxpayers were issued for the years involved in those cases, in deciding whether to appeal, the taxpayers would be expected to consider whether an appeal would endanger the *Hill* decision and jeopardize the taxpayers' apparent certainty of receiving tax refunds on this same issue for their open (and future) taxable years not before the Tax Court. That would be tantamount to threatening the goose that lays golden eggs. It is thus improbable that the few taxpayers who found it necessary to assert this issue in the Tax Court would seek further review from an adverse Tax Court decision. The administrative and fiscal consequences of the decision of the court of appeals are, in any event, better dealt with now than later, after hundreds of expensive and time-consuming administrative claims and audits are needlessly conducted.

2. Contrary to respondents' arguments (Br. in Opp. 11-20), the Internal Revenue Code provides that the adjusted basis of a "mineral deposit" does not include the depreciable improvements that form part of the "mineral enterprise." Respondents do not dispute that "the adjusted basis of the property" referred to in Section 57(a)(8) of the Internal Revenue Code is, by specific reference to the definition of "property" in Section 614, the adjusted basis of each separate "mineral deposit." And, both parties agree that the adjusted basis of a mineral deposit for purposes of Section 57(a)(8) is to be determined under Section 1016 and its regulations. See 26 C.F.R. 1.57-1(h)(3). Section 1016 provides that the cost basis of any asset is to be adjusted "for expenditures * * * or other items[] *properly chargeable to capital account*" (26 U.S.C. 1016 (emphasis added)). In this regard, the Treasury Regulations provide (26 C.F.R. 1.1016-2(a)):

> The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a deduction in computing net or taxable income for the taxable year. For example, in the case of oil and gas wells no adjustment may be made in respect of any intangible drilling and development expense allowable as a deduction in computing net or taxable income. * * *

Respondents err, however, in contending that depreciable tangible property is "properly chargeable

to [the] capital account" (26 C.F.R. 1.1016-2(c)) of a "mineral deposit." The crux of respondents' error, and that of the courts below, lies in their refusal to recognize that the "mineral deposit" and the depreciable tangible improvements have their own *separate* capital accounts and, accordingly, separate bases. This is because, as explained in our petition (Pet. 3), the taxpayer is allowed a *separate* deduction for the depletion of the mineral deposit and for the depreciation of the costs of tangible improvements (26 U.S.C. 611).[1] As a result, separate capital accounts must be maintained for the mineral deposit and for the depreciable improvements. 26 C.F.R. 1.611-2(b)(1), 1.611-5(c).[2]

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[1] Historically, and theoretically, the depletion deduction reflects the principle that taxpayers with an economic interest in a mineral deposit must be able to recover their cost or investment in the mineral deposit before realizing income. The earlier Acts provided that depletion should be allowed on the basis of cost unless the taxpayer was the discoverer of the well upon an unproven tract, in which case the basis was the "value of the property" at the time of the discovery or within 30 days thereafter. *Palmer* v. *Bender*, 287 U.S. 551, 556 n.1 (1933). The Revenue Act of 1926, however, eliminated the "discovery value" provision and allowed the taxpayer to calculate depletion on the basis of cost alone, or else to deduct an arbitrary allowance, fixed by the statute, without reference to cost or discovery value, based on a percentage of gross income from the well. See *United States* v. *Dakota-Montana Oil Co.*, 288 U.S. 459, 461 (1933).

[2] The Treasury Regulations require every taxpayer claiming a deduction for depletion of mineral property to keep a separate account accurately recording the cost or other basis of such property as provided by Section 1012, together with subsequent allowable capital additions to each account and all of the other adjustments required by Section 1016. 26 C.F.R. 1.611-2(b)(1). They also provide that accounts for depreciable improvements are to be maintained in accordance with Section 1.167(a)-7, by treating each individual item as an account, or by combining two or more assets in a single account. 26 C.F.R. 1.611-5(c).

Pursuant to the plain language of the applicable statutes and regulations, the adjusted basis of the mineral deposit thus includes only the costs of improvements to the "mineral deposit" that are properly chargeable to *its* capital account.[3] The costs of depreciable improvements are therefore not properly added to the capital account of the mineral deposit under the regulations pertaining to depletion.

Respondents assert (Br. in Opp. 13-14) that it is inconsistent to include the costs of intangible improvements in the adjusted basis of the mineral deposit, but not the costs of tangible improvements. See note 3, *supra*. Nearly 60 years ago, however, this Court rejected the similar contention that there is no logical basis for distinguishing between tangible and intangible improvements to mineral property with respect to the recovery of their cost through the separate methods of depletion and depreciation. See *United States* v. *Dakota-Montana Oil Co.*, 288 U.S. 459 (1933). The taxpayer in that case sought to depreciate its capitalized intangible development costs. The government took the position that the claimed deduction was properly for depletion, rather than depreciation. The government's rationale was that the intangible expenses in drilling a well did not

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[3] Examples of costs that are properly chargeable to the capital account of a mineral deposit are the costs of acquiring the deposit and also the intangible drilling and development costs (IDC's)—such as amounts paid for labor, fuel, repairs, hauling, and supplies used in the drilling of wells or in the preparation for drilling—*if* the taxpayer elects to capitalize the costs rather than to deduct them. 26 C.F.R. 1.612-4(a).

create a tangible property that wears out with use or has a salvage value (*id.* at 462, 466). In holding for the government, the Court explained (288 U.S. at 465):

> development costs other than the cost of physical property incident to the development must be returned through the depletion allowance, but the regulations also provided expressly that the cost of "physical property such as machinery, tools, equipment, pipes, etc.," should be returned by an annual allowance for depreciation.

The Court noted that this distinction was continued under subsequent tax statutes until the provision respecting depletion was, in 1924, amended to provide for a reasonable allowance for depletion to be established under rules and regulations prescribed by the Commissioner. *Ibid.* The regulations that the Commissioner adopted have maintained this same distinction. See 26 C.F.R. 1.612-4(a) and (b).

Respondents recognize (Br. in Opp. 17-18), as they must, that Section 1.612-1(b) specifically provides that "the basis for cost depletion of mineral or timber property does not include * * * [a]mounts recoverable through depreciation deductions." Respondents are wrong, however, in arguing that this is a "special rule" that is not applicable to this case. As we have shown, it is the general rule that the costs of depreciable property are not to be included in the basis of the "mineral deposit" (regardless whether cost or percentage depletion is used) because such costs are not "properly chargeable" (26 C.F.R. 1.1016-2(a)) to the capital account of the mineral deposit.[4]

[4] The capital account, and hence the adjusted basis, for all mineral properties is calculated in the *same* manner, without regard to whether cost or percentage depletion is used. See 26 C.F.R. 1.611-2(b). The regulations covering the determination of percentage depletion under Section 613 do not specifically address basis, as does Section 1.612-1(b) dealing with cost depletion, because basis is not relevant in computing percentage depletion, which may be taken even though the property's entire basis has been recovered. See 26 C.F.R. 1.611-2(b)(2).

For the foregoing reasons, and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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